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**AUDIT RISK
ALERTS**

Securities Industry Developments—1994

Complement to AICPA Audit and Accounting Guide
Audits of Brokers and Dealers in Securities

AICPA

American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of brokers and dealers in securities with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Albert F. Goll
Technical Manager, Accounting Standards Division

Gerard L. Yarnall
Director, Audit and Accounting Guides

The staff of the AICPA is grateful to the members of the AICPA Stockbrokerage and Investment Banking Committee for their contribution to this document.

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Securities Industry Developments—1994

Industry and Economic Developments

The securities industry experienced record revenues and earnings in 1993. Revenues and earnings of New York Stock Exchange member firms dealing with the public were \$73.2 billion and \$8.6 billion for the year ended December 31, 1993. Daily trading volume averaged 264.5 million shares, and the pretax return on equity averaged 27.1 percent. Although growth in the general economy is expected to continue for the balance of the year, the trend is not benefitting the securities industry because of the effect that such growth may have on interest rates. Increasing interest rates as a reaction to inflationary pressures negatively affected earnings of securities firms in several areas for the first half of 1994 compared with last year's first six months. It reduced underwriting income due to decreased volume, adversely affected returns on the portfolios of brokers and dealers in securities (broker-dealers), many of which had been positioned to anticipate less volatility in interest rates, and reduced earnings from sales of mutual funds because investors hesitated to commit additional funds in an uncertain market. As a result, after record annual earnings for 1993, the securities industry anticipates that 1994 may be its worst year since 1991.

As they assess audit risk, auditors of financial statements of broker-dealers should consider the auditing ramifications of developments significant to the industry. The following three such developments, in particular, are noteworthy: (1) the use of derivative financial instruments, (2) the accelerating emphasis on cost control, and (3) the continuing globalization of products.

Although the securities industry benefitted from the expansion of the derivative products market, in number of transactions, types of products, and number of derivative product customers, it is currently feeling the negative impact of adverse publicity. The innovative and complex nature of the products themselves, and limited authoritative accounting literature related to these products, increases audit risk. (See the "Regulatory and Legislative Developments," "Audit Issues and Developments," and "Accounting Issues and Developments" sections of this Audit Risk Alert as well as *Audit Risk Alert—1994* for discussions of derivatives.)

The ramifications of the October 1987 market crash, the excesses of the leveraged buyouts of the 1980s, and the uncertain outlook for economic recovery in the 1990s have caused many broker-dealers to reduce long-term debt and reengineer operations to operate more efficiently and competitively. Retrenchment and cost-containment measures, such as downsizing, right-sizing, reengineering, and outsourcing, have become the rule, not the exception. The negative results in 1994 within the securities industry have accelerated this trend; selective layoffs are expected to continue and even expand as the year continues. At the end of 1993, employment at New York Stock Exchange member firms stood at 244,000. Some believe that reductions may be as much as ten percent by year-end 1994. (See the "Audit Issues and Developments" section of this Audit Risk Alert.)

As a result of worldwide ideological transformations and the anticipated changes in the European Community, the move toward the globalization of the securities and commodities industry continues. Many broker-dealers have placed an emphasis on accessing new markets, such as the Commonwealth of Independent States, the Eastern Community, and China. (See the "Audit Issues and Developments" section of this Audit Risk Alert.)

Regulatory and Legislative Developments

Regulation of Broker-Dealers

The regulation of broker-dealers is discussed in chapter 1 of the Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* (the Guide). The following discussion is intended to help auditors stay abreast of developments that affect the regulation of broker-dealers.

Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), requires that, in planning their audits, auditors consider matters affecting the industry in which an entity operates, including, among other things, government regulations. Auditors consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), distinguishes between the following two types of laws and regulations:

1. Those that have a direct and material effect on the determination of financial statement amounts
2. Those that relate more to an entity's operating aspects than to its financial and accounting aspects and, therefore, have only an indirect effect on the financial statements

Although auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that directly and materially affect financial statement amounts, an audit performed in accordance with generally accepted auditing standards (GAAS) does not include procedures specifically designed to detect illegal acts that would have only indirectly affected financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

The securities industry is subject to extensive regulations by a number of federal and state authorities. As a result, auditors of broker-dealers should be familiar with the applicable rules and regulations of governmental agencies and other regulatory bodies, including the Securities and Exchange Commission (SEC) and industry member regulatory bodies such as the National Association of Securities Dealers and national securities exchanges such as the New York Stock Exchange.

Auditors of broker-dealers who are also commodities brokers should consider the rules and regulations of the Commodity Futures Trading Commission (CFTC). The CFTC was created by Congress in 1974 and is the federal agency with regulatory and oversight responsibility for the trading of commodity futures and options contracts on the U.S. futures exchanges. Since 1982, the CFTC has also regulated operations on futures contracts and options on physical commodities trading on commodity markets.

A summary of a number of the recent regulatory developments that may affect the audits of broker-dealers follows.

SEC Releases

SEC Release No. 34-33761. In 1994, the SEC issued proposed amendments for the calculation of capital charges to better reflect the market risk for listed options (on equities, indices, and currencies) and related positions. The amendments proposed to Rule 15c3-1 would allow broker-dealers to use a theoretical pricing model developed by the Options Clearing Corporation to determine haircuts for broker-dealers' listed options positions and related positions. The proposed amendments will not change the current strategy-based haircut method for over-the-counter (OTC) options.

SEC Release No. 34-32256. In 1993, the SEC issued a concepts release on derivative products that addresses how such products should be treated in computing broker-dealers' statutory net capital requirements. The SEC broadly defines a derivative product as a financial instrument that derives its value from the performance of other assets, including securities, interest rates, or indices. Financial Accounting Standards

Board (FASB) Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, Current Text, vol. 1, sec. F25), defines derivative financial instruments for purposes of that statement as, "futures, forward, swap, or option contracts, or other financial instruments with similar characteristics." The current net capital treatment of financial instruments used in formulating derivatives is described in the release and includes listed and unlisted options, swaps, forwards, futures, and options on futures. Credit risk is also recognized as a significant risk in derivative products. The SEC is studying the comments received on the proposal.

SEC Release No. 34-32609. In 1993, the SEC proposed amendments to the broker-dealer record preservation rule that would allow broker-dealers, under certain conditions, to employ optical storage technology to maintain required records. Another proposed amendment would codify a staff interpretation that allows broker-dealers to use microfiche for record-retention purposes. Although the proposed rules have not been made final, the SEC staff issued a letter to the Ad Hoc Record Retention Committee of the Securities Industry Association (SIA) allowing the use of optical storage technology providing that certain requirements, enumerated in the letter, are met. A copy of the letter can be obtained by written request to the SIA, 120 Broadway, New York, NY 10271.

SEC Release No. 34-32748. In 1993, the SEC issued a concepts release that solicits comments on a number of questions regarding the treatment of foreign-equity securities under the ready-market provisions of the net capital rule, Rule 15c3-1 of the Securities Exchange Act of 1934. In a related development, the SEC staff took an interim no-action position, which permits broker-dealers to treat foreign-equity securities that are listed on the FT-A World Indices as having a ready market in computing statutory net capital requirements. The SEC is studying the comments received on the release to determine whether proposed rule making or other action is appropriate.

FOCUS Report Revision

The staffs of the SEC and the CFTC, in cooperation with the Capital Committee of the SIA, are revising the Financial and Operational Combined Uniform Single (FOCUS) report, which is the uniform regulatory report required to be filed with regulators. The CFTC permits futures commission merchants (FCMs), who are also registered broker-dealers, to file the FOCUS report instead of the currently required CFTC Form 1-FR. After the revised FOCUS report has been approved for use, the CFTC intends to allow FCMs, whether or not

they are broker-dealers, to file CFTC reports using the new FOCUS report. The revised report is expected to prohibit broker-dealers from including subordinated debt in a combined total with equity on the balance sheet. However, no change is anticipated that would prohibit including qualifying subordinated debt in regulatory net capital.

Other SEC Concerns

The SEC's Division of Market Regulation has noted, in various public forums, the matters in the following sections that frequently incur comments on materials filed with the SEC or that have been identified by the SEC's field inspection process. If auditors become aware, during the course of audits, that such transactions have not been reported in the financial statements as recommended, they should consider the effect on the amounts presented in the financial statements of such deviations and whether, in accordance with SAS No. 54, the audit committee or others with equivalent authority or responsibility are adequately informed about the matter.

Derivatives and Other High-Risk Investments. This joint Statement of the SEC, the CFTC, and the Securities and Investments Board emphasized the importance of management controls over derivatives and the need for improved accounting and disclosure rules for derivatives. It listed the following concepts that management controls should include.

1. Policies about derivative activities should be promulgated by the board of directors and should be reviewed as business and market circumstances change.
2. Execution of these policies should be supported by valuation procedures and techniques, risk management, and information systems designed to ensure the adequacy of both management information and external reporting.
3. Responsibility for implementing the policies should be clearly delineated and the board of directors should define appropriate levels of and delegated authority for those responsible for implementing board policies for supervising OTC derivatives activities.
4. Information systems should be designed to achieve full compliance with policies and principles, assist in the active management of derivatives activities, and provide an adequate flow of relevant information about derivatives activities not only of the firm, but also of its related entities on a worldwide basis.
5. Appropriate expertise should be maintained at all levels of a firm.

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6. Internal controls should include units that are independent of trading personnel, report directly to senior management, and are dedicated to the evaluation of credit, market, and legal risks.
 7. Appropriate use should be made of risk reduction techniques, such as master agreements and credit enhancements, including collateralization.

Offsetting of Repurchase and Reverse Repurchase Agreements. With regard to repurchase and reverse repurchase agreements, the SEC staff has noted that these are being netted in the balance sheets of brokers and dealers in circumstances in which all the criteria of paragraph 5 of FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FASB, *Current Text*, vol. 1, sec. B10), have not been met. For example, the criterion of paragraph 5(c) of FASB Interpretation No. 39 requires that the reporting party intend to set off the contracts. This condition is not satisfied if the two parties do not intend to settle with each other in a single net payment.

The FASB proposed an interpretation that would permit offsetting in the statement of financial condition of payables and receivables that represent repurchase and reverse repurchase agreements meeting certain conditions. (See the "Accounting Issues and Developments" section of this Audit Risk Alert.)

Sponsor (Adviser) Reimbursement of Fund Losses on Derivatives or Other Investments. Recent reports in the financial press have indicated that the sponsors (advisers) of certain money market funds have purchased derivatives or other investments from the funds at an amount in excess of the fair value of those investments. The SEC staff believes that the excess of the purchase price over the fair value of the investments acquired should be reflected as a loss in the financial statements of the fund sponsor.

Internal Revenue Service Developments

The Internal Revenue Service (IRS) continues to emphasize information-reporting compliance. The daily sales and purchases of shares and frequent cash distributions made by broker-dealers subject them to numerous IRS reporting regulations. Such regulations generally relate more to broker-dealer operational aspects than to their financial and accounting aspects. For example, the failure to properly file information returns, such as Form 1099DIV reporting dividends to shareholders, with the IRS can result in substantial penalties. Accordingly, auditors should refer to SAS No. 54 for guidance on the nature and extent of consideration that should be given to illegal acts.

Access to Working Papers

Examiners from the SEC's Division of Market Regulation, as well as others, may from time to time request auditors of broker-dealers to provide access to working papers. Auditors who have been requested to provide such access should refer to Interpretation No. 1 of SAS No. 41, *Working Papers*, entitled "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, AU sec. 9339). The Interpretation provides auditors with guidance on—

- Advising management that the regulator has requested access to (and possibly photocopies of) the working papers and that the auditor intends to comply with such request.
- Making appropriate arrangements with the regulator for the review.
- Maintaining control over the original working papers.
- Considering submitting to the regulator a letter clarifying that an audit in accordance with GAAS is not intended to, and does not, satisfy a regulator's oversight responsibilities. (An example of such a letter is illustrated in paragraph 6 of the Interpretation.)

In addition, the Interpretation addresses situations in which an auditor has been requested by a regulator to provide access to working papers before the audit has been completed and the report released. Also, the Interpretation notes that if a regulator engages an independent party, such as another independent public accountant, to perform the working paper review on behalf of the regulatory agency, there are some precautions auditors should observe.

The complete text of this Interpretation was published in the July 1994 issue of the *Journal of Accountancy* ("Official Releases").

Audit Issues and Developments

Investments in Derivatives

As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments derive their value have increased in volatility over the past several months, a number of entities have incurred significant losses as a result of their use. Broker-dealers sometimes use such instruments as risk management tools (hedges) or as speculative investment vehicles. The use of derivatives virtually always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditor's approach to achieving related audit objectives may differ because certain derivatives—such as futures

contracts, forward contracts, swaps, options, and other contracts with similar characteristics—are not generally recognized in the financial statements. Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1994*.

Valuation of Securities

Investments generally represent one of the most significant assets in broker-dealers' statements of financial condition. For this reason, the valuation of investment securities is a prime concern for auditors of broker-dealers.

As investment strategies increasingly include investing in more complex and higher risk securities, the values of securities may not be readily available through market quotation. Such securities are often valued at amounts determined by the broker-dealers' management, which may use valuation experts to determine such values. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), which is effective for audits of periods ending after December 15, 1994, provides guidance when auditors decide to consider the work of any specialist used. Auditing the valuation of such securities is an area that requires a high degree of judgment and scrutiny to ensure that the valuation procedures are reasonable and underlying support is appropriate. Chapter 4 of the Guide describes the estimation of fair values of securities in good faith by management. In auditing securities valuations determined by management, auditors should review the information in determining the value of the securities and ascertain that the procedures followed were reasonable. In some instances, auditors may consider using the work of a specialist in auditing the valuation of such securities.

Cost Control

Because of the anticipated continuing contraction of volume and other negative factors in the securities industry for the balance of 1994, broker-dealers may initiate or accelerate existing staff termination programs. Auditors should be aware of the consensus of the FASB's Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, as it relates to how termination expenses related to such programs are to be accounted for.

Auditors of broker-dealers should refer to Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (FASB, *Current Text*,

vol. 1, sec. I13), for guidance to determine whether a segment of a business as defined therein has been disposed of and, if so, that the requirements of APB Opinion 30 have been complied with.

In addition to focusing management's emphasis on cost controls, worsening business conditions may intensify some managements' tendency to emphasize favorable accounting policies, such as anticipating revenue while postponing expense recognition. Auditors should be alert to such tendencies with an awareness that they may have significant consequences to broker-dealers because of the possible effects on statutory net capital requirements. Serious abuse could cause statutorily required net capital to become insufficient, leading to the discontinuance of business. Should such conditions arise, auditors should refer to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), for further guidance with respect to evaluating whether there is substantial doubt about an entity's ability to continue as a going concern. (See *Audit Risk Alert—1994* for further discussion of audit risks related to adverse business conditions.)

Globalization

Auditors should be alert to factors that affect the financial statements of broker-dealers effecting transactions in foreign securities. The effects on broker-dealers' financial statements of the following should be considered:

- There are custody issues related to the receipt and delivery of securities, the collections and payments of dividends and interest, information gathering, and processing. Foreign custody agents must qualify under SEC Rule 17f-4, governing the eligibility of depositories.
- Custody requirements vary by country. Settlement cycles, as well as holiday schedules, are usually different. Seldom, except in the United States, is the timing such that shares and money are exchanged simultaneously. In some clearing environments, the actual delivery of shares takes place more than twenty-four hours before payment. Therefore, counterparty risk and the process for choosing counterparties are important factors.
- The means of settling transactions in different countries can be dissimilar. Depending on the marketplace, book shares, physical shares (both registered and bearer), issuers' receipts, or transfer agent receipts may be the norm for transferal of ownership.
- Trading in offshore markets may involve the use of foreign exchange (FX) transactions to convert into the local currency of the foreign

market. FX transactions are another kind of contract with their own risks and liabilities.

- Each country has its own unique rules as they relate to certain transactions that are exceptions. The issues here may be whether short sales are allowed in the trading environment, whether a stock loan is a business in that market, and the regulatory issues relating to contract closeouts.
- Tax and regulatory issues within a foreign market are another of the considerations to review. Issues relating to the withholding of taxes, principal and income repatriation, and proper registrations are important within that market. The U.S. rules, as they relate to a U.S. broker-dealer transacting business in the international marketplace, are also a variable that affects business.

Service Auditors' Reports

Broker-dealers frequently use the services of fund custodians, transfer agents, and other service organizations that affect assertions in a broker-dealer's financial statements. In obtaining an understanding of a broker-dealer's internal control structure and assessing control risk, auditors should carefully consider the functions or processing performed by service organizations. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), which was issued in April 1992 and supersedes SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*, provides guidance to auditors of entities that use service organizations and is applicable to audits of broker-dealers.

SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), requires an auditor to obtain a sufficient understanding of an entity's internal control structure to plan the audit. If a broker-dealer uses a service organization, control structure policies and procedures at the service organization that affect the functions or processing performed by the service organization may have a significant effect on assertions in the broker-dealer's financial statements. The internal control structure of the broker-dealer may include a component that is not directly under its control and monitoring at the service organization. For this reason, planning the audit of a broker-dealer may require that the auditor gain an understanding of the control structure policies and procedures performed by a service organization. If a broker-dealer relies on a service organization's control policies and procedures over the processing of transactions that are material to the broker-dealer's financial statements, these policies and procedures should be considered by the auditor.

One method of obtaining information about these policies and procedures is to obtain a service auditor's report as described in SAS No. 70. Auditors frequently ask whether it is necessary to obtain a service auditor's report if their clients use service organizations. The fact that an entity uses a service organization does not, in itself, mean that such a report must be obtained. In certain situations, the broker-dealer may implement control policies and procedures that will obviate the need for a service auditor's report. For example, a broker-dealer using a payroll service may routinely compare the data submitted to the service organization with reports received from the service organization to check the completeness and accuracy of the data processed. The broker-dealer may also recompute a sample of the payroll checks for clerical accuracy and review the total payroll for reasonableness. In such circumstances, the broker-dealer is not relying on the service organization's controls.

Other factors that may be considered in determining whether to obtain a service auditor's report are—

- Whether the transactions or accounts affected by the service organization are material to the broker-dealer's financial statements.
- The extent to which the user organization retains responsibility for authorizing the transactions and maintaining the related accountability.
- The availability of other information (for example, user manuals, system overviews, and technical manuals) at the broker-dealer that may provide the auditor with sufficient information to plan the audit.

The AICPA's Auditing Standards Division is expected to issue an Auditing Procedure Study entitled *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations*, in the first quarter of 1995.

Accounting Issues and Developments

FASB Statement on Derivatives

The FASB issued FASB Statement No. 119 in October 1994. The Statement requires improved disclosures about derivative financial instruments—futures, forward, swap, or option contracts, and other financial instruments with similar characteristics. The Statement is effective for fiscal years ending after December 15, 1994 (except for entities with less than \$150 million in total assets, for which it is effective for fiscal years ending after December 15, 1995). Auditors of

financial statements of broker-dealers that are parties to derivative transactions should consider whether the disclosures made by their clients in their financial statements are adequate and appropriate in view of the new requirements.

Proposed FASB Interpretation

The FASB has issued an exposure draft of a proposed Interpretation, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*. The proposed Interpretation would permit offsetting in the statement of financial condition of payables and receivables that represent repurchase and reverse repurchase agreements that have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in "book entry" form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System (Fedwire system).

The provisions of the Interpretation would be effective on issuance. Previously issued financial statements may be restated to apply the provisions of the Interpretation retroactively to the date Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, was applied.

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This Audit Risk Alert replaces *Securities Industry Developments—1993*.

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Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1994*, which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022141 (audit) or 060688 (compilation and review).

Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.